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SEC ENFORCEMENT MATTERS

Recent Amendments to the Securities Exchange Act Pose New Risks for Private Fund Managers

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With the recent passage of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (NDAA), Congress sought to restore the SEC's power to seek disgorgement of ill-gotten gains from violations of securities laws. The NDAA amends the Securities Exchange Act of 1934 (Exchange Act) to grant the SEC explicit authority to seek disgorgement and to extend the statute of limitations to seek disgorgement for certain violations. A response to the decisions by the U.S. Supreme Court (Court) in *Kokesh v. SEC* and *Liu v. SEC*, which imposed significant restrictions on the SEC's ability to seek disgorgement, those amendments could significantly increase the financial exposure of defendants in securities investigations and may shift the SEC's enforcement priorities.

This article summarizes those changes; assesses their impact on private fund managers and others regulated by the SEC; and considers how *Kokesh and Liu* may yet restrain the SEC's ability to seek disgorgement even following the NDAA.

See "How the SEC May Circumvent the Five-Year Statute of Limitations on Disgorgement Under *Kokesh v. SEC*" (Jul. 20, 2017).

Background

The SEC's Disgorgement Authority

Since the 1970s, the SEC has sought to require defendants in enforcement actions to "disgorge," or repay, their gains from allegedly unlawful activity.

Previously, the SEC's authority to seek disgorgement was grounded in a provision of the Exchange Act allowing the SEC to seek "equitable relief." Because disgorgement was |an equitable remedy at common law, the SEC maintained that the Exchange Act's reference to equitable relief authorized it to pursue disgorgement for violations of the securities laws.

The SEC also has authority to seek civil monetary penalties. For various reasons, however, disgorgement has historically been a more powerful enforcement tool. Civil monetary penalties are generally awarded on a tiered basis, with the amount of the penalty determined at the court's discretion in light of the facts and circumstances, and relevant factors might include the nature of the conduct,

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the defendant's cooperation and any remedial action. A court might therefore impose a lower civil penalty to account for mitigating factors.

Disgorgement, on the other hand, does not require the same weighing of factors. Even a cooperative defendant could be required to give up all of its purported ill-gotten gains under a disgorgement theory. Moreover, because disgorgement has roots in equity, the SEC need not prove the precise amount of the ill-gotten gains with specificity; a reasonable approximation will suffice.

For those reasons, disgorgement has played a key role in the SEC's enforcement strategy. In each of the past six fiscal years, the amount of total disgorgement obtained by the SEC has been two to three times higher than the amount of monetary penalties obtained. In Fiscal Year 2020, for example, parties in SEC proceedings were ordered to pay more than $3.5 billion in disgorgement – and only around $1.1 billion in penalties.

For additional discussion of disgorgement as a remedy, see "Disgorgement Action Reveals Dangers of Having an Unqualified CCO" (Apr. 16, 2020).

The *Kokesh* Decision

Prior to 2017, the SEC had an additional reason to prefer disgorgement to monetary penalties: a five-year statute of limitations applied to a government action for the enforcement of any "civil fine, penalty, or forfeiture," but some courts had concluded that the five-year statute of limitations did not apply to disgorgement. Thus, disgorgement allowed the SEC to reach back further in time to secure a larger monetary recovery.

In *Kokesh*, the Court unanimously held that disgorgement was a "penalty" as that term was used in the statute of limitations. Thus, disgorgement was subject to a five-year limitations period. Penalties, said the Court, have two basic characteristics. First, penalties are intended to address wrongs to the public, not wrongs to individuals. Second, penalties are imposed for the purposes of punishment and deterrence as opposed to compensating victims for their losses.

The Court held that disgorgement, as imposed by the SEC, had both characteristics. It was imposed to address public wrongs – securities violations – and for the primary purposes of punishment and deterrence, not compensation to the victim. The Court noted that disgorged profits were often paid to the court rather than to the victims. In addition, courts ordering disgorgement sometimes required a defendant to pay more than it personally gained from the alleged misconduct, leaving the defendant worse off rather than simply restoring the status quo.

Kokesh, however, limited its analysis to the meaning of penalty as used in the statute of limitations. The Court never addressed the question of whether disgorgement was punitive in a way that removed the remedy from the scope of equitable relief that Congress had authorized the SEC to pursue.

See "Implications for Fund Managers of the Supreme Court's Ruling in *Kokesh v. SEC*" (Jun. 15, 2017).

The *Liu* Decision

In *Liu*, the Court answered the question that *Kokesh* left open. It concluded that disgorgement qualified as equitable relief –

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but only if the remedy adhered to the traditional limits of the disgorgement remedy at equity. For example, because the equitable disgorgement remedy permitted recovery only of a defendant's net profits, the SEC's disgorgement authority also could not extend beyond recovery of net profits.

The Court also cast doubt on the SEC's practice of depositing disgorged funds with the U.S. Treasury Department rather than returning the funds to victims. In addition, under most circumstances, the SEC could not impose disgorgement on a wrongdoer for benefits that accrued to others. The Court reasoned that, traditionally, a defendant could only be liable for wrongful profits he or she personally received. Holding defendants liable for others' gains – for example, under a joint-and-several liability theory – the Court explained, could transform the equitable profits-focused remedy into a penalty.

See "Supreme Court Scales Back SEC's Disgorgement Remedy in *Liu v. SEC*" (Jul. 16, 2020).

Impact of Those Decisions

The *Kokesh* decision had an immediate impact on the SEC's enforcement efforts. In 2019, the SEC estimated that it had forgone approximately $1.1 billion in disgorgement due to the five-year limitations period imposed by *Kokesh*. In light of *Kokesh*, the SEC also changed its enforcement priorities to focus on investigations with the most promise for returning funds, at the expense of efforts to recover from long-running frauds in which conduct may have occurred outside the five-year limitations period.

Liu had a similar effect. Following that decision, the SEC suggested that it may need to shift its enforcement strategy to focus more on pursuing monetary penalties.

The SEC, however, did not take those decisions lying down. In 2019, then-SEC Chair Jay Clayton criticized *Kokesh* in public remarks, arguing that the decision hampered the SEC's ability to return the proceeds of long-running frauds to investors. Clayton publicly called for Congress to "address this gap in investor protection."

Congress heard the SEC's complaints. After two bills addressing the SEC's disgorgement remedy failed to pass, Congress ultimately enacted Section 6501 of the NDAA.

See "What Remedies and Relief Can Fund Managers Expect in SEC Enforcement Actions?" (Jan. 10, 2019).

Restoration of the SEC's Disgorgement Authority

Independent Statutory Authority To Seek Disgorgement

Under the previous version of the Exchange Act, the SEC's authority to seek disgorgement was implied from its authority to seek "equitable relief . . . for the benefit of investors." The NDAA, however, explicitly endorses disgorgement as a remedy the SEC may pursue, stating, "In any action or proceeding brought by the Commission under any provision of the securities laws, the

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Commission may seek, and any Federal court may order, disgorgement." Thus, the disgorgement remedy has been untethered from the SEC's authority to seek generic equitable relief, ostensibly taking aim at the Court's decision in *Liu*.

Extended Limitations Period for Disgorgement

The NDAA also sought to reverse the Court's ruling in *Kokesh* that disgorgement actions were subject to a five-year limitations period. The NDAA expands that limitations period to ten years for many violations of the securities laws, including violations of:

- Section 10(b) of the Exchange Act, which prohibits use of manipulative or deceptive devices in contravention of SEC rules;
- Section 17(a)(1) of the Securities Act of 1933, which prohibits use of interstate commerce to defraud;
- Section 206(1) of the Investment Advisers Act of 1940, which makes it unlawful to defraud clients or prospective clients; and
- any other provision of the securities laws for which scienter must be established.

In the securities fraud context, "scienter" generally means conduct engaged in with intent to manipulate, deceive or defraud. Many courts also agree that even recklessness – a lesser standard – qualifies, although the Court has not yet decided that issue.

For more on scienter, see our two-part series on the *Robare v. SEC* decision: "Court Says Negligent Conduct Is Not Willful Conduct" (Aug. 8, 2019); and "Implications for Advisers and the SEC" (Aug. 15, 2019).

Application of the Amendments to Pending Cases

Significantly, the NDAA amendments apply to any action or proceeding that is either pending on, or commenced on or after, the date of the NDAA's enactment. Because the NDAA expands the limitations period for seeking disgorgement in response to many securities violations from five years to ten, it effectively resuscitates a disgorgement remedy for a whole host of cases and conduct that had been previously time-barred.

The SEC has wasted no time in pursuing this expanded disgorgement remedy in pending cases. On January 29, 2021, the SEC filed a letter in a pending case, SEC v. Sason, stating that it plans to seek disgorgement under the expanded limitations period provided in the NDAA. In Sason, the SEC had alleged nearly $700,000 of ill-gotten gains. More than $275,000 of those gains, however, accrued outside of the five-year limitations period. Following passage of the NDAA, however, the SEC notified the court and the defendant that it now intended to seek disgorgement of those gains, dramatically increasing the defendant's potential liability in the middle of the litigation.

Impact of the Amendments

The recent amendments dramatically expand the scope of the SEC's ability to seek disgorgement. Those changes are likely to impact private funds, their managers and other regulated entities in several ways.

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Increased Financial Exposure for Targets of SEC Investigations

With the timetable for disgorgement expanded to ten years, targets of SEC enforcement face dramatically increased potential liability, which will be a powerful tool for the SEC in settlement negotiations.

The NDAA also appears to increase financial exposure by affirming the SEC's expansive view of precisely which gains may be disgorged. Before *Liu*, the SEC took the position that, when more than one individual or entity was involved in the securities violation, disgorgement could be imposed jointly and severally. In other words, any single defendant would be liable for the entire amount of disgorgement – even if that defendant did not personally receive all of the gains. Moreover, the SEC did not credit operating expenses and other costs against the amount of disgorgement. *Liu* cast doubt on the viability of those practices, suggesting that the equitable roots of disgorgement limited the remedy only to profits that were actually received by the individual defendant.

Because the NDAA creates an explicit disgorgement remedy, the SEC may take the position that it is untethered from the generic remedy for equitable relief that the Court considered in *Liu*. Because *Liu*'s restrictions on disgorgement were rooted in the traditional equitable remedy, the SEC may argue that those restrictions no longer apply. Doing so would allow the SEC to continue its pre-*Liu* practices of seeking joint and several disgorgement liability and refusing to credit operating expenses and other costs when calculating the disgorgement amount. The end result would be to further increase the potential liability for those accused of violating the securities laws.

Potential Changes in SEC Enforcement Priorities

Post-*Kokesh*, the SEC changed its enforcement priorities to focus on investigations with greater potential to yield financial return, such as more-recent violations for which disgorgement was available under the then-applicable five-year statute of limitations. Under the new amendments, the SEC can be expected to reverse that trend. It now has incentives to pursue older and longer-running violations in which the bulk of investor loss occurred between five and ten years ago.

The SEC can also be expected to focus its efforts on violations that carry the expanded limitations period for disgorgement – that is, violations of Section 10(b), Section 17(a)(1), Section 206(1) and violations requiring scienter. Because disgorgement has generally been more lucrative for the SEC than civil penalties, the SEC can now be expected to pursue even more zealously cases in which disgorgement may be ordered.

Questions About the Scope of the SEC's New Authorities

Because Congress enacted the NDAA in response to the Court's decisions in *Kokesh* and *Liu* – and the limits those decisions placed on the disgorgement remedy – the SEC will almost certainly argue that the amendments reversed those decisions. The courts, however, may not be so quick to agree. The exact reach of the new disgorgement provisions will ultimately be determined by the courts, and there are good reasons to think that the courts may not blindly accept the expanded disgorgement remedy that Congress created in the NDAA.

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First, the disgorgement limitations that *Liu* recognized may yet survive the NDAA amendments. Although Congress created an explicit disgorgement remedy in the NDAA, it did not define the term. It did, however, suggest that disgorgement is limited to "unjust enrichment by the person who received such unjust enrichment as a result of the violation." Such language could be interpreted to preserve *Liu*'s limitations.

Moreover, as the Court explained in *Liu*, disgorgement is a historical term with an accepted historical meaning. When Congress uses such terms without otherwise defining them in the statute, courts typically presume that Congress intends for the term to carry that historical meaning. Thus, courts might conclude that the NDAA's use of disgorgement was simply a reference to the historical remedy described in *Liu*. Indeed, nothing in the NDAA's legislative history suggests that Congress intended its use of the word disgorgement to carry any meaning other than the historical meaning of the term as described in *Liu*.

Therefore, courts might conclude that even the NDAA's disgorgement remedy is subject to the limitations of the traditional disgorgement remedy at equity. Those limitations would include not only those described in *Liu* but also all other limitations imposed at equity – including the unavailability of pre-judgment interest and the need for the SEC to tie disgorgement to an identifiable loss by specific victims. As a result, disgorgement might be unavailable in cases in which the SEC cannot identify specific victims or offer a reasonable approximation of their losses.

Second, even if courts conclude that the NDAA did create a new disgorgement remedy untethered from the historical limits of equitable disgorgement, the Constitution may yet provide important safeguards against the abusive use of the new disgorgement authority. *Liu* recognized that adherence to the equitable limitations of disgorgement was necessary to avoid transforming disgorgement into a penalty. If the disgorgement remedy in the NDAA has been severed from those equitable limits, a court could conclude that the new disgorgement remedy is, in fact, a penalty. That conclusion would trigger various constitutional limitations on the SEC's authority to seek disgorgement.

For example, punishments – whether civil or criminal – are subject to the Eighth Amendment's prohibition on excessive fines. Under the Eighth Amendment, a fine must bear some relationship to the gravity of the offense it is designed to punish. A grossly disproportionate disgorgement award could potentially implicate the so-called "Excessive Fines Clause" and be invalidated by a court.

Moreover, defendants faced with harsh disgorgement orders may also argue that those fines are so punitive that they should be considered criminal in nature. If the fines were treated as criminal fines, they would be subject to still more constitutional limits, including the "Double Jeopardy Clause" and "Ex Post Facto Clause." Under the Constitution's Double Jeopardy Clause, a defendant cannot be tried or punished twice for the same criminal offense. Thus, a defendant who has received a disgorgement order that qualifies as a criminal punishment might argue that the judgment in the SEC enforcement proceeding renders him or her immune from further criminal prosecution for the conduct underlying that violation.

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For an example of a case in which both criminal and civil charges were pursued for securities violations, see "Manager Accused of 'Cooking the Books' Facing Civil and Criminal Fraud Charges From SEC and DOJ" (Jul. 12, 2018).

The Ex Post Facto Clause prohibits Congress from retroactively changing the law applicable to pending criminal cases or conduct that occurred prior to passage of the statute. Thus, if a court were to view the NDAA's disgorgement remedy as criminal in nature, the Ex Post Facto Clause would prohibit its application to pending enforcement actions or to conduct that occurred before the NDAA's enactment.

The threshold question for the Double Jeopardy and Ex Post Facto analyses, however, will be whether the disgorgement award is criminal in nature. Although some courts have previously rejected the argument that SEC disgorgement penalties are criminal penalties, *Liu* and *Kokesh* could lead courts to reconsider that conclusion – particularly if the SEC interprets the NDAA to provide for a more expansive disgorgement remedy than previously permitted.

When considering whether a sanction is civil or criminal, courts consider first whether Congress expressly indicated a preference for a civil or criminal label. If Congress indicated a preference for a civil label, as it did in the NDAA, courts then assess whether the statutory scheme is so punitive that it transforms what was intended as a civil remedy into a criminal penalty. Among other things, the court considers whether:

1. the penalty requires a finding of scienter;
2. the penalty is intended to promote retribution and deterrence; and
3. the behavior to which it applies is already a crime.

All three considerations could weigh in favor of applying the criminal label to a disgorgement remedy that sheds the limitations described in *Liu* and *Kokesh*.

Although courts may be reluctant to treat disgorgement as a criminal sanction, the risk of bringing disgorgement within the purview of the constitutional constraints on criminal sanctions might itself be enough to deter the SEC from seeking excessively harsh disgorgement awards. These arguments might also be used by targets of SEC enforcement to negotiate a favorable settlement and to counterbalance some of the settlement pressures that the NDAA places on targets.

Conclusion

Although the precise scope of the SEC's new disgorgement authority remains to be seen, there is no doubt that the NDAA amendments will be a game-changing tool in SEC enforcement investigations and actions.

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